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**Cooperation and Asymmetry**  
**The Development Profile of an East-West**  
**Corporate Project\***

Gerlinde Dörr and Tanja Kessel

\*We would like to thank the company Škoda-Volkswagen for making our empirical studies possible. And especially for permitting corporate research over a longer period of time, enabling us to do better justice to the processual character so important in such constellations.

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Wissenschaftszentrum Berlin für Sozialforschung gGmbH (WZB)

Reichpietschufer 50, 10785 Berlin

Telephone: (030) 254 91-0

homepage: <http://www.wz-berlin.de>

## Abstract

This paper deals with a case of transnational cooperation between companies. The profile of cooperation between the two motor vehicle makers Skoda and the Volkswagen Group is reconstructed, characterised by the interlocking transformation and globalisation.

Decisive for the success of the project was not only Volkswagen's substantial transfer of know-how and management resources to the Czech manufacturer but also how it was approached. The utilisation of existing Škoda competencies was crucial in providing the stability needed for the learning process.

The study discusses findings at three levels of integration: corporate, regional, and international. In contrast to the success achieved in international integration, the regional integration of the company has been slow.

The authors conclude that this discrepancy was to be expected, given the unequal resources available to international firms and to local industry, and is not primarily to be explained by the tendency often attributed to so-called global strategy players of external concentration on the group network. The case has rather shown that limited regional integration has been largely due to the policy pursued by the Czech government in the important early years of transformation, which failed to generate the necessary domestic efforts in restructuring.

“The company Skoda Auto a.s. is now not only the most successful industrial enterprise in the Czech Republic, it has meanwhile gained an outstanding position within the entire Volkswagen Group. Precisely because we are dealing with such a ‘success story,’ it seems appropriate to take stock of the historical and economic development of the company over the past ten years.”

Dr. Klaus Pumberger, formerly of the Friedrich Ebert Foundation, Prague.

“This essay offers a thorough analysis of the many-faceted environment and a highly informative account of the solutions achieved. A ‘must’ for anyone engaged in entrepreneurial or advisory activities in the region—also beyond big industry.”

Dieter Mankowski, Director of the German-Czech Chamber of Industry and Commerce

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## I. Introduction

One of the essential features of globalisation is doubtless the trend towards convergent, transnational developments. Paradoxically, however, the region has also become more important. This dual aspect of globalisation poses a considerable challenge for transition countries in their endeavours to catch up with international developments. And it was soon evident that merely converting the production system from plan to market did not suffice for this purpose, and that the path chosen towards modernisation often did not lead all the way to the goal. The industries most affected were those that had to hold their own in international markets. Given the intensified competition and dynamics in these markets, it was obvious that the companies relying solely on their own resources would be unable to catch up.

In this situation, another aspect of globalisation offered unexpected help: the pressure for the greater international location of production. This gave transition countries the opportunity to stimulate restructuring through direct investment. Although investment from abroad offered more chance of attaining this goal, there was no guarantee that it would bring qualitative progress for local industries and the region. Even if globalisation had enhanced the general importance of the regional component with regard to both costs and innovation, it seemed that the cost factor would be most likely to make Eastern Europe interesting, and that the existing structural level of the region's industrial culture would prove resilient.

Given the asymmetric constellation, with the region's countries and industries strongly dependent on the transfer of capital and know-how and a political actor weakened by radical systemic change, negotiating power was extremely limited, but—as developments have shown—far from insignificant. As the case described in this paper shows, the deployment of regional competence resources in setting the course for restructuring was an important factor. Moreover, the resulting transformation regime of enterprise, investor, and political actor points to two more general considerations. First, the defence of these interests by regional actors remains important even if the global actor also safeguards them and integrates local innovation potential. Second, even with an international player operating strongly on a regional basis, problematic disparities can arise if the institutional prerequisites for inter-sectoral linkages and cooperation are lacking.

The paper describes and discusses the tension between global and regional networking and the performance of the transitional regime in the case of cooperation between the Czech motor vehicle manufacturer Škoda and the German Volkswagen Group.<sup>1</sup> Even

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<sup>1</sup> The account is based on findings of the research unit Transformation and Globalisation at the Science Center Berlin and empirical surveys that the authors carried out between 1995 and 1997 at Škoda-Volkswagen. They included intensive interviews with company experts from management (foreign and local executives) and with shop-floor workers. Also included were trade union representatives and

though we are dealing with a very high-profile enterprise, and are thus evidently concerned with its specificity, the informative value of the case is a great deal broader, precisely because of the importance of the firm to the region and because it offers an example of an internationalisation strategy. Our account therefore tries to strike a balance between ‘dense description’ and condensed problematisation.

The paper addresses the three key relationship levels of the transformation regime, which set the course for cooperation. We deal firstly with the strategy level, the conditions and processes that led to cooperative consensus and which constitute the setting for the global-regional orientation. We then turn to the work level, to the implementation of strategy in three selected areas: products and competence development, production modernisation and transfer management, and with regard to the supply industry. Finally, we extend the perspective to the governmental actor, in order to assess, at least to some extent, the development of the company and the sector in comparison with national industry.

## **II. The Strategy Level: Foreign Investor and Government**

### **1. Starting Point and General Setting**

#### *The Market*

At a relatively early date after the socialist system foundered and the regime changed in 1989, intensive discussions were taken up between Eastern and Western European motor vehicle manufacturers. In no other industrial sector were potential buyers quicker off the mark or production facilities so sought after for investment or takeover. The dynamic observable particularly among major high-volume producers was due to the new markets and expansion promised by the opening of the borders. Central and Eastern Europe offered the prospect of winning new market shares and sales in grand style—growth un hoped for in Western motor vehicle markets owing to the prevailing strong international competition.

With the dearth of vehicles in Eastern Bloc countries—there were only 2.5 million cars for 420 million people; 80 cars per thousand inhabitants in the East compared to 500 in the West—rapidly rising growth potential was expected to materialize in the course of ‘catch-up motorisation’. It is thus not very surprising that Western motor vehicle manufacturers showed a strategic interest in the region at an early date, initiating negotiations with existing producers. After all, the car was one of the most desired

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representatives from the group executive board. This paper concentrates more strongly on the strategic actor level and the framing of the relationship between regional and global linkages.

It should be pointed out in advance that we refer to joint venture and cooperation in the context of Škoda-Volkswagen although these terms no longer apply in the strict sense, takeover now being appropriate. However, we have continued to use the first two terms because the focus is on effective processual interaction rather than on formal relations.

consumer products, whose production had persistently lagged far behind demand because of the notorious systemic restrictions. Investing in manufacturers established in the region promised not only access to a big new market region but also major expansion of capacities.

Among the foremost objects were FSM in Poland and the Czech manufacturer Škoda, whose privatisation offered such opportunities. The point of departure for Western European producers differed widely. There were differences in market entry options, in investment strategy, and in knowledge about the manufacturing sites concerned. The Italian Fiat group was in a privileged position, having long maintained relations in the form of licensing agreements with Poland, the Soviet Union, and Yugoslavia under the socialist regimes, and which therefore enjoyed an advantage over others in competing for FSM. French producers also had experience with concrete projects; Renault had invested in the Romanian enterprise Dacia quite some time back, and Citroën had had links with the Olcit works, also in Romania. The other two major manufacturers GM/Opel and Volkswagen, on the contrary, were largely newcomers in the transition economies.

If one recalls the situation as it existed immediately after the political turnaround when investment decisions had to be made, forecasts on market development were anything but certain. It was not just that political and economic conditions were highly unstable; probably much more importantly for entrepreneurial investment projects, there was no reliable knowledge about inventories, plant, and utilisable resources at Eastern European production sites, because the countries concerned had been so comprehensively insulated. At the same time, the early privatisation of motor vehicle producers by the governments of the region and the comparatively large number of Western competitors exerted considerable pressure to act. This was particularly apparent in the case of Škoda, the second major concern available in the region after the Poles had rapidly opted for the established partner Fiat in the case of FSM.

### *The Object*

The sale of Škoda involved not only the monopoly in the domestic Czech market but also succession to an established leading position in the other Eastern European countries. With regard to competence resources, too, Škoda had attracted a certain amount of attention among experts beyond the Eastern Bloc during the socialist period despite the deficiencies and backwardness of the products. The tradition of the firm as one of the very oldest car manufacturers in the world and the fact that the company had written automobile history at a very early date played a particular role in this, but there was more to it. Even under the socialist regime the fundamental structures of an independent car maker had been maintained, thus safeguarding technical standards and basic development. Contrary to the traditional motor vehicle makers in the old GDR, for example, Škoda and the Czech automotive industry suffered no comparable

downgrading. The company had maintained its salience in national industry, and accordingly enjoyed preferential investment. Škoda shared this position with other, so-called status enterprises, which received preferential treatment under the socialist regime because their exports to the West earned foreign exchange. These narrow corridors allowed a certain transfer of know-how and permitted a marginal closing of the West/East technology and performance gap. Škoda's eminent position gave a certain scope for ameliorating products and production structures and for maintaining its leading position in Eastern Europe. In comparison with FSM, producing under Western licence, Škoda also benefited from the outset from a higher technological level. Among Eastern European motor vehicle makers, Škoda thus had relatively most to offer, and in the past the Škoda product had managed to uphold its reputation as a comparatively reliable vehicle.<sup>2</sup>

A distinctive feature closely associated with traditional manufacturing sites—in Eastern Europe too—is an infrastructure of supplier and customer networks, of labour markets and cooperative relationships firmly established in the region. In the Czech location and in the region this had remained largely intact, owing to the uninterrupted—albeit diminished—operation of this industrial sector. The attractiveness of Škoda for foreign investors is therefore to be seen not only against the background of the competence the company already possessed; it is also due to the network of interfirm relationships and the regional infrastructure.

### *The Investor*

The bid for Škoda was made while Carl Hahn still headed the VW Group. With their highly favourable appraisal of the Eastern Europe market—there was talk of an ‘unparalleled megamarket’<sup>3</sup>—top management also signalled the group's determination and interest in continuing the consistent improvement of Volkswagen's strategic market position in Europe with the acquisition of Škoda. Hahn's assessment drew particularly on the prospect of succeeding to the traditional Czech manufacturer's leading position in East-Central and Eastern Europe, and his eye was thus primarily on Škoda. With the explicit purpose of expanding Volkswagen's strategic market position in mind, he visited the region early in 1990 at the head of an expert delegation from the Federation of German Industry, using the occasion to indicate his interest in investing.

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<sup>2</sup> During the socialist period Škoda had been present on some Western markets (including Britain) with the model Favorit—of course, only in small numbers and at dumping prices. This “narrow window on the West” is likely to have given considerable stimulus to product development. Cooperation with Porsche and Bertone lent targeted impetus to design development at Škoda before 1989. The resulting improvements in products are likely to have been important in maintaining the level of Western exports.

<sup>3</sup> Hahn in *Berliner Zeitung*, 11 December 1990. According to optimistic estimates, demand was expected to rise to about ten million cars within ten years (*die tageszeitung*, 11 December 1990).

In 1990, at the time of the planned projects in the transition countries, the Volkswagen Group was at an historic peak in the world market. Not only had it passed the mark of three million cars sold, maintaining its fourth rank among major manufacturers after General Motors, Ford, and Toyota,<sup>4</sup> Volkswagen was also number one in the European market for the sixth time in a row. Full order books and long delivery times were signs of persistently strong demand for all three brands, VW, Audi, and Seat. In terms of sales and turnover, 1990 was the most successful business year to date in the history of the company.<sup>5</sup>

Operating from a position of strategic market power and strength, and mindful that failing to take action risked abandoning Eastern Europe to its direct competitors,<sup>6</sup> Volkswagen tackled the envisaged investment projects in East Germany and in the CSFR relatively soon after the opening of the borders. In the context of a DM 5 billion investment programme, two new VW plants were set up in the former Trabant combines in East Germany,<sup>7</sup> followed shortly afterwards by the much bigger Škoda project to the tune of DM 9 million.

Commitment to establishing group manufacturing sites in the transition countries was considered important not only to gain strategic access through early market entry, but also because the situation in Western markets was increasingly difficult. After almost a decade of prosperity, a downturn was expected in the group's Western markets for the 90s. The locations in Eastern Europe and the strong development of sales expected in that region were thus also seen as an opportunity to compensate the likely decline in the West in not inconsiderable measure through new projects in the East, thus improving the overall costs position.

Generally speaking, the Hahn era at Volkswagen was dominated by the strategic goal of internationalisation. Under his leadership Volkswagen plants were built in South

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<sup>4</sup> In 1986 the Japanese car maker Nissan had been displaced from 4th rank. The new goal was to overtake the global player Toyota.

<sup>5</sup> The point needs to be relativized. For the success story production figures and turnover seemed to tell was belied by the development of the concern's earnings position. The discrepancy between these two factors is indicative of increasing cost competition and inefficient production structures, closely associated with the Japanese challenge and the 'lean production' concept, which imposed fundamental rationalisation and modernisation on the Western automotive industry as a whole (on the VW path see Jürgens 1998).

<sup>6</sup> In comments on these investment projects made by Hahn at the time and more recently, considerable emphasis was placed on the possibility of obtaining a leading position in Eastern Europe for the group through Škoda (interview with Hahn, 16 January 1996). For Hahn this was not one option among many that could also be taken up later. He saw the opening up of Eastern Europe as an historical opportunity. In such a situation he felt it would be a mistake not to act or to do so only hesitantly. "When a world is on the move ... you have to go along with it. The risk of missing out on these developments is much greater than that of helping to shape them" (quoted in *Die Zeit*, 14 December 1990). The main competitors involved were the two high-volume producers Fiat and Renault. Fiat had to be overtaken, since the Italian group was already established in the region—in Poland and the USSR, and Renault proved to be the main rival for Škoda (see below).

<sup>7</sup> A complete new car factory for the VW models Polo and Golf was constructed in Mosel close to Zwickau, and the modernisation of existing engines was located in Chemnitz.



America, China, and Europe. Volkswagen thus gained competence in internationalisation at an early date, which still today distinguishes the group from many other Western European producers.<sup>8</sup> This being the case, it is not surprising that Eastern Europe was given extremely high priority under Hahn after the opening up of the region. In a brief span of time, a whole series of investment projects emerged in addition to those in East Germany and the Škoda plans, in Slovakia, Poland and Bosnia. A little later, the subsidiary Audi invested in Hungary. In terms of the total amount spent, VW was the biggest investor in the regions in its sector.

In considering the motives for the accelerated expansion of the group in the transition countries under Hahn, one final aspect concerning the internationalisation concept in a qualitative sense needs to be stressed. Basically, the VW approach to internationalisation followed a pattern of ‘equality among production locations.’<sup>9</sup> The core element of the concept is that the decentralised foreign manufacturing sites were not integrated into the classical division of labour between centre and periphery—with corresponding gradation. A guiding factor was to develop or maintain basic core functions at all production sites. The philosophy of equality was associated with the fundamental facilitation of upgrading for industrially backward manufacturing regions and a preference for tying in with decentralised, regionally established networking and relationship structures. As we will show, the two elements were to prove important factors in the Škoda negotiations and for the further development of the company in the cooperation project. From the point of view of the VW Group, promoting equality for less developed sites was motivated not only by the new combination of costs and quality competition in the markets, but also by the desire to create and exploit competition between manufacturing locations within the group. While Hahn still placed greater stress on securing a broad innovation potential, under his successor Piëch the focus shifted more strongly to generating synergies through interaction between sites. However, the internationalisation approach with its comparatively strong basis in competence has been retained. Equality was indispensable if the new manufacturing locations were to participate increasingly in demanding development and production projects.<sup>10</sup> And this provided the basis for the wider use of the more flexible group-wide division of labour provided by greater standardisation and technological networking for qualitative processes and innovations—a flexibilization

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<sup>8</sup> This is also true of other up-market German manufacturers like BMW and Mercedes, which, unlike Volkswagen, internationalised production only very late in the day. Internationally, however, the German and European automotive industries as a whole still lag far behind the Americans and Japanese.

<sup>9</sup> Cf. Hahn interview 16 January 1996. Of course, this does not mean homogeneity in the sense of absolutely equal status, but the option of development beyond the mere low cost/low skill/low tech specification.

<sup>10</sup> An example of such upgrading is offered by the VW plant in Mexico, which was given the contract for the new Beetle—a product intended for the American and Western European markets.

that, through this qualitatively expanded competitive mechanism, blurred the traditional dividing line between high-cost central regions and low-cost peripheral regions.<sup>11</sup>

## 2. Negotiations on Cooperation

### *Preferences*

The rapid privatisation of Škoda through sale to a foreign investor was in one way untypical of the Czech approach to transformation. For, in contrast to neighbouring countries, the Czech government did not pursue any sort of incentive policy to attract foreign direct investment, having instead specifically espoused a national strategy for the restructuring of core industries. If Škoda was treated differently than, for example, mechanical engineering firms, it is probably due to the realisation that, without external help, it would not be possible to position the firm rapidly in a sector with strong international integration and subject to global competition. Furthermore, Škoda is a very small enterprise by international standards—with a capacity of 180,000 vehicles—and it was probable that, in view of the emerging consolidation in the automotive industry, it would be unable to hold its own as an independent manufacturer. An international solution was therefore sought for this sector from the very outset.<sup>12</sup>

Volkswagen was not the only Western car maker interested in taking over Škoda. Others included Volvo, General Motors, and Renault. Only two stayed the course, and the competition between them was correspondingly fierce: the French concern Renault and the German Volkswagen Group. In the Czech camp, preferences were divided between the two. The political leadership, including President Havel, were strongly in favour of cooperating with the French. There is every reason to think that political motives played a role in this preference. For at this early stage the Czech attitude towards Germany and the Germans was generally still very critical, and broad sections of society had great reservations about the neighbours.<sup>13</sup> It was feared that a German takeover of the

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<sup>11</sup> Intragroup competition and the flexible division of labour, which, from the viewpoint of the less developed and backward production sites doubtless constitute a desirable upgrading option, quite clearly present the traditionally highly developed high-cost manufacturing centres with the prospect of competence loss. The globalisation metaphor for increasing locational competition therefore conceals not only the 'simple' production cost factor—which is the general view—but also a possible setback in the level of development achieved in the old industrial regions. Playing locations off against one another, especially in the field of core competencies, can be considered one of the main problems currently facing trade unions, and which has led to new supraregional mergers like European and world-wide employee councils. For more details on this general problem see Dörr/Kessel 1999b.

<sup>12</sup> Apart from Škoda, this also affected the second Czech car maker Tatra. The firm's cooperation with an American company failed, however, and car production under this brand name is now at an end.

<sup>13</sup> These reservations go back to experience during and after the war in both countries—the Munich Agreement, Nazi occupation, the later expulsion of the Sudeten Germans—and to the extreme difficulty in achieving political understanding after the change in regime. There was also uneasiness about the reunified Germany as a political and economic 'major power' in Europe, while the secession of Slovakia from the Czechoslovakia state made the country even smaller (the final separation came at the end of

renowned and time-honoured enterprise Škoda would revive old tensions and conflicts. The Czech leadership elite<sup>14</sup> is likely to have had a quite different but also obvious reason for preferring the French buyer, namely Renault's state governance regime. From a socialist perspective, (stronger) state management was generally to be seen as more appropriate than a purely private regime for major companies so prominent in the national economy. The French are therefore not unlikely to have advanced this argument during negotiations, especially since President Mitterand and representatives of the department of industry also intervened personally in Prague.

The German Volkswagen Group had the support of the more enterprise-oriented actors, in the first place the Škoda workforce itself, as well as the union and—with effective public impact—the Czech press. This grouping shared a conviction that only a “genuinely” economic solution would strengthen the position of the enterprise, and that this was the only way to regain international competitiveness. This camp did not expect the ‘state enterprise’ Renault to press ahead with decentralised company structures but rather to continue the ‘state subsidy culture’ unlikely to attain genuinely corporate objectives or to cope effectively with competition.

Negotiations were not made any easier by the differences in strategic preference among the Czechs, with those in favour of the state-political solution arguing for greater economic responsibility while the other side warned about the dangers of subsidies and stagnation; and with the advocates of an entrepreneurial solution pleading for development and competitiveness while others pointed to the risks of competition and a loss of autonomy. Moreover, apart from the hard facts of investment and restructuring programmes, these legitimisation discourses were pivotal in the decision-making process. Negotiations were protracted owing to the even match between bidders, the ambivalence of Czech preferences, and prevailing reservations and uncertainties—with the positive effect for the Czechs of higher offers and repeated outbidding between the two competitors. What finally tipped the balance in favour of Volkswagen was an extremely high investment programme of over DM 9 billion. The proposed Renault programme had amounted to ‘no more than’ DM 5 billion. The fact that Renault ultimately attempted to compensate the much higher German offer with additional non-monetary incentives—there was talk of oil supplies and cooperation in the nuclear power business—shows the strategic importance attributed to the Czech company in the Eastern European market. Volkswagen's high investment and the associated double promise it offered of international competitiveness and greater corporate competence made it easy for the Czech government to abandon its earlier preference for Renault. Moreover, the demand of the Škoda workforce for an economic solution exerted considerable legitimisation pressure. Škoda workers threatened strike and resistance if

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1992).

<sup>14</sup> If the Czech leadership elite is spoken of in general in this context, this is not to imply that there were no differences of opinion within the group. However, the majority showed a preference for Renault.

Renault were to be chosen. The overwhelming vote of Škoda employees was influenced not only by the economically more advantageous VW offer but also by the better social benefits and pay VW generally provided.

### *Persuasion*

There were factors over and above economic issues in the narrow sense that tipped the scales in favour of VW, and which largely centred on the person of the chief German negotiator, CEO Hahn.

In strong contrast to Renault, the German side was represented in the negotiations by a high-ranking delegation of industrial representatives headed by Hahn himself. The emphasis was thus clearly on demonstrating economic competence. The change of mind on the part of the Czech government is likely to have been influenced not inconsiderably by the business ethics orientation which became clear in the course of talks. One point marking the turnaround is a speech held by Hahn in which he pleaded the VW case, not without convincing references to the country and its people, and in which he expressed his high regard for Czech industrial competence and Czech motor vehicle manufacturing.<sup>15</sup> In stressing the value of Škoda's corporate tradition, and the competence of the company's engineers and skilled workers, VW management addressed a collective identity aspect important to the Czechs, especially considering the high symbolic value of Škoda for the country over and above the enterprise itself.

In this case, cultural recognition was extremely important. In the presentations and negotiations on the Volkswagen project it was essential to keep the politically difficult German-Czech relations constantly in mind. It was not only necessary to gain approval for the investment and restructuring project, and of course to have the means and will to carry it through. The basic trust of the Czech side had to be won. And in the person of Carl Hahn, Volkswagen had an important agent for this type of 'trust capital.' Two elements in particular spoke for the credibility of the position presented. First, the image of the German automotive industry, the international reputation of German technology and quality production, which was enjoyed not only by German prestige manufacturers but also by Volkswagen, the high-volume makers of the 'People's Car.' In other words, Volkswagen's company history itself authenticated the professions of respect for engineering competence and the maintenance of technological development in strong congruence with Czech value orientations.

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<sup>15</sup> In the literature on international management, increasing weight is being put on the importance of competence in establishing a relationship with the history and culture of the host country and taking them into account in any action envisaged. Technical-economic 'tunnel vision' in managerial action—'management without culture' as it were—is identified as a fundamental inadequacy and the cause of high social costs. On the relevance of 'intercultural competence' cf. Bolten 1995.

The second important circumstance was that Hahn could cite Seat as an impressive demonstration of VW's competence in restructuring a state enterprise. At this point in time, the Spanish subsidiary Seat was still indisputably and demonstrably a critical project that had been successfully mastered. It could serve as evidence that the group was really determined to respect the structures of an established manufacturing company and to preserve the brand tradition. The example of Seat also vouched for Volkswagen's willingness to make substantial transfers in the course of a takeover, for in this case a similar investment programme had already been largely realised and the enterprise modernised in line with German quality and technology standards.<sup>16</sup> Seat, like Škoda, had been a relatively small producer unable to finance development on its own, and which, after being taken over by VW, had become an internationally competitive brand of the group. The analogy with Seat was thus a further convincing argument for the seriousness of the project that was able to allay fears of Škoda being downgraded.

### *Agreements*

A similarly decisive factor was the restructuring concept agreed along with the investment programme. It was perhaps still more important than the mere dimensions of investment in defeating the Renault bid. No comparable agreement had been reached with Renault on restructuring goals that the Czechs considered fundamental. The Czech government had made the sale conditional on a commitment by the investor to obviate mere 'catch-up modernisation' let alone downgrading. (The imposition of such conditions on the foreign investor depends very strongly on the type of investment envisaged, whether equity stake/cooperation, take-over, or so-called greenfield investment. In the last case the investor is usually least bound by such conditions, and if at all they are usually part of the 'subsidy pact' and are not concerned with production in the narrower sense but with job-creation associated with the investment. In the case of a purchase or participation in existing manufacturing operations, such conditions are usual. That such far-reaching demands could be made in the case of Škoda is indicative of the company's leading position in national industry and that the enterprise was very attractive for Western European car makers with ambitions in the Eastern European market).

There were essentially three demands:

- to safeguard the status of the firm as a full car maker and to continue the historic Škoda brand;

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<sup>16</sup> All Seat plants were modernised and a new factory was built, and, in particular, the product range was renewed. VW's took over Seat in the mid-80s. The two firms had previously cooperated in development after the long-standing partner FIAT had withdrawn in 1980, and the Spanish company needed a new partner for technology transfers. In return, Seat produced VW models (Polo) and made the existing Spanish service network available, giving VW entry to the Spanish market (FAZ 17 September 1993, SZ 11 December 1986).

- to involve and safeguard the regional supplier sector in the Škoda restructuring and modernisation programme;
- and to pursue a strategy of capacity expansion and innovation enabling Škoda to meet international competition and ensure its long-term survival as a motor vehicle manufacturer.

This last condition required adoption of a restructuring concept involving no serious job losses. Over and beyond the interest in maintaining employment levels, it was also a question of preserving existing competence and accumulated knowledge for the continued expansion of production.<sup>17</sup>

Renault's unwillingness to make notable concessions in negotiating these conditions left the impression that a takeover by Renault would not so much benefit the Czech production site but—very much in line with the centralised national strategy characteristic of the French company—serve to strengthen the parent group on its home ground, a strategy that raised fears at Škoda that the Czech firm could find itself reduced to a mere assembly-supplier operation. In the worst case scenario the status quo would be not even be maintained and structures and competence lost that had been the resources for generating autonomous development capacities.

The weight placed on these considerations by the Czech government was, however, also due to another factor. The manufacture of motor vehicles is a key industry in the country, with Škoda as the core element. Cutting the company's regional and network ties, or, vice versa, severing regional components suppliers from their established customer would necessarily erode both Škoda and the supply industry, provoking serious dequalification and deindustrialization. East Germany offers a graphic example of such a course of events: the strategy of separating out core competencies from industrial sectors and dissolving networks important to enterprises and production engendered a process of industrial disintegration there that assumed the dimensions of radical deindustrialization involving the loss of existing resources, which are now no longer available for restructuring.

In contrast, the restructuring and modernisation concept proposed by Volkswagen, which envisaged a substantial increase in capacity with a view to market expansion in Eastern Europe and market entry in Western Europe, implied not only preservation and catch-up modernisation but also the need to upgrade the products and production structures of the manufacturer and regional suppliers. This strategic intention of the German investor made it possible for the Czech side to reach agreement more easily and on a more consensual basis with VW than with Renault, and an agreement taking

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<sup>17</sup> This demand was unacceptable to General Motors, for example. The American producer believed that what Škoda needed first of all was to downsize the workforce, which was much too high by Western standards. In 1990, 21,000 workers at Škoda produced 183,000 vehicles. This was five times the standard GM level, so that the demand to maintain manning levels put an end to negotiations.

account of these considerations was in fact concluded. And in view of the rapid expansion of production planned—it was to be doubled to 400,000 units, a target met in the sixth year of cooperation—the transitional phase was not expected to last very long, so that the demand to maintain manning levels was not an insurmountable obstacle for Volkswagen.

In return, the Czech government offered Škoda-Volkswagen an institutional ‘framework’ to reduce costs and protect against competing foreign products on the domestic Czech market. In the form of special terms, it consisted largely of customs relief and tax exemptions for technical equipment and components and an import duty policy that offered improved Škoda products produced with VW know-how market protection against imported vehicles for a period limited to four years.

### 3. Governance and Regulation

The major investment programme that won the day for Volkswagen in the competition to take over Škoda received a great deal of attention from the international press and from the motor vehicle industry in Western Europe. The Škoda project was a clear signal at an early date that Volkswagen’s strategic intention was to become market leader in Eastern Europe. The privatising policy adopted by the then Czech government at the very outset of transformation facilitated Volkswagen’s rapid entry. Even if participation initially took the form of an only 30% minority holding, the takeover was contractually agreed from the beginning, and the German investor had the prerogative to make strategic decisions. In a five-year transitional phase, it was planned to raise VW’s stake to 70% in 1995 with a later option for the remaining shares.

This procedure of step by step participation culminating in a controlling interest for Volkswagen and which left the majority of shares in the hands of the Czech government in the initial phase proved advantageous in a number of ways. In this period the Czech side retained important monitoring powers over the modernisation agreements, while the undertaking to grant VW a majority interest largely eliminated the uncertainty that usually arises in ‘open cooperation’ projects, and which often makes productive and effective dealings difficult. This structure obviated the danger of a know-how drain to potential competitors—which often occurs in fixed-term and project-related ventures—and allowed an intensive transfer and exchange. Moreover, no uncontrolled and unapproved deviation from the contractual agreements was possible. In the notoriously problematic initial phase of joint ventures<sup>18</sup> when understanding has to be achieved, when the trust needed for implementing the project has to be established, such structures can be important correctives, as in the case described.

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<sup>18</sup> The M&A literature shows that the majority of projects fail in the initial phase. Omissions, lack of transparency, deficient integration management, and inadequate communication are cited as the main reasons for the frequent failure (on the integration problem cf. the overview by Dörrenbacher et al 1997).

### *Crisis*

In 1992/93 the worldwide recession in the motor vehicle industry and the change in the leadership of the VW Group caused radical changes in the Škoda/Volkswagen project and prompted a very serious conflict, which put cooperation under lasting strain. In reaction to the market slump, which hit Volkswagen particularly badly, the top controlling body at VW, the supervisory board, demanded a cut in the group's investment plans. The measure was to apply for all group manufacturing locations. However, the newest projects in the East were worst affected. In contrast to the older and established production sites, the Eastern projects—a good two years after the opening of the borders—were still in their infancy. The not inconsiderable investment projects seemed eminently suitable for cuts, because they offered the greatest potential for savings. The big Škoda project was particularly targeted, ultimately suffering a DM 6 billion cut to DM 3.5 billion.

Škoda was hit by this drastic reduction in the third year of the joint venture, in the medium-term investment planning for the period between 1994 and 1998. The cuts led not only to irritation and tension between the two parties but also to a serious conflict. The Czech government was under strong public pressure to bring its position as majority shareholder to bear and insist on the agreements been fulfilled. The conflict developed into the biggest and most serious to date in the history of the Škoda/VW venture.

It is remarkable that no breach in relations took place, for the statements of the time reveal a profound crisis of trust. Naturally, the violence of Czech reactions was due primarily to concern about the further development of an industry so important for the country, and which had always been very dependent on the one enterprise Škoda. Furthermore, Škoda was regarded as a genuinely Czech company, and the country was confronted by the fact that Škoda was now embedded in a superordinate group context and directly affected by problems caused elsewhere. This was articulated in the demand that Škoda should not be made 'liable' for the difficulties of the group. From this point of view, the conflict also demonstrated the new experience that Škoda was no longer an independent company in the traditional sense, being integrated into a group and thus tied—for better or for worse—to the overall destiny of that group.

If a breach was nevertheless avoided, it was probably due to the high-flying strategic goals of both sides—the Czechs sought international competitiveness and access to Western markets, and VW wanted to become established in the Eastern European market and succeed to Škoda's leading position in the region—and to the implicitly shared conviction that these ambitions could best be attained with each other. The changes, improvements, and visible progress in development already achieved in the few years of the undertaking played a not inconsiderable role. For example, the then Czech minister of industry was of the opinion that no Czech product had to date experienced



such development as the Škoda product, and that it would be a hazardous step backwards for the company to change partners at this stage (Dlouhy in FAZ 25 April 1994).

### *Conflict Regime*

The irritation with and criticism provoked by the immense cutback in investment were nonetheless great. The situation was exacerbated by an omission on the part of the new VW leadership under Ferdinand Piëch. High-handedly and without consulting the main actors involved, Piëch stopped a major European loan of DM 1.4 billion for the Škoda-VW project, doing so immediately before the signing date for the agreement.<sup>19</sup>

Even if the economic losses suffered by Volkswagen made the revision and downsizing of investment plans appear inevitable, the way the VW Group management went about it was interpreted as contempt of the other actors involved and an objective breach of contract and trust. The high-handedness of the proceedings was particularly offensive considering that, at this point in time, the Czech government still held the majority of shares in the company.<sup>20</sup>

The affront was levelled not only at the Czech government as VW's partner in cooperation but also at the international banks involved as major financiers, and, not least of all, at the local Škoda management. Like the government and the banks, the Škoda-VW board of management had not been fully involved in the decision, but, unlike the other players, it gave its loyal and active support. In this situation the key German representative in the Škoda management, deputy chairman of the board Köhler made an energetic effort to win the support of the relevant circles. He argued that the decisive factor was not the amount invested but the concrete implementation of the project, claiming that Volkswagen had never called this in question.<sup>21</sup>

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<sup>19</sup> The robust approach of the new Volkswagen CEO in the matter of investment cuts at the very beginning of his term of office prefigured the future strategy and leadership pattern, which gave precedence to cost efficiency—a pattern that was to become predominant throughout the group in association with the name Piëch.

<sup>20</sup> Czech opinion was divided on whether the cuts constituted a breach of contract. Particularly the economists among the critics conceded that strategies and investments could not be handled without reference to the general economic situation, and did not regard the cuts as a breach of contract in the narrower sense of the term. However, this conflict revealed another point, namely that the components of the agreements differed widely in their binding force. The economic-strategic components were flexible, the political were binding. In the situation that had now arisen, the Czech side found itself at a disadvantage, and recognition that the agreements concluded differed in binding force had not prevented the Czech government from bringing the binding elements into play as flexible components. For example, it threatened to rescind the brand protection for Škoda for foreign cars.

<sup>21</sup> In press releases issued by Škoda the investment cuts were not mentioned. The restructuring project was not called in question, but it was claimed that “such high financing from outside sources” as originally planned was no longer needed (cf. FAZ 18 September 1993).

The banks also reacted very negatively, for the Škoda-Volkswagen financing credit they had provided was considered a model for participation in a major European project. 47 banks had contributed, including the European Bank for Reconstruction and Development (EBRD). It had been the bank's biggest private project to date. And for the first time banks had been involved that had never financed Eastern European projects. This constellation lent the Škoda-Volkswagen project international repute and was a positive signal to other investors to support such private large-scale projects in the region. The back-peddalling by VW management and the form it assumed—taking place shortly before the signing of an agreement that had taken over two years to elaborate and by cursory announcement that the group's progress in productivity had rendered the agreement unnecessary—was considered a provocative violation of the standards prevailing in the international business world, and as harmful for the development of confidence among Western investors for future commitments in the transition countries. The investment cuts and cancellation of the bank loan heavily damaged not only relations at the corporate strategy level but also cooperation at the operative plant level. Substantial political harm had also been done. The reaction of the Czech media made this abundantly evident, which now revised their initially favourable attitude towards the German Volkswagen Group as a partner for Škoda. The German side had now earned itself an extremely critical and distrustful press for the foreseeable future, which would associate developments at Škoda that were in any way ambiguous with severe negative consequences for the company. This situation demanded considerably more caution on the part of local German executives in their endeavours to regain lost trust than had hitherto been imposed by the difficult German-Czech relations in and after the war.

One of the most important effects of the conflict was to politicise the project to a much greater degree. The Czech side now demanded renegotiation of existing agreements, and made their consent to the planned acquisition by Volkswagen of a controlling interest contingent on the agreed modernisation goals actually being attained. Moreover, the supplemental agreement was accompanied by a strengthening of the Czech government's rights of control and co-determination in the key corporate governance body, the supervisory board. The legitimisation needed and finally achieved for the investment cuts also demanded of Volkswagen that it accept an amendment to the agreement by which the fundamental 'Škoda terms,' such as the preservation of the company as a motor vehicle manufacturer, were reaffirmed. This had become necessary once the severe cuts in capital spending had rekindled the old but not extinguished fears that Škoda could after all lose its status as a manufacturer to become a mere assembly plant and supplier for the VW Group. The supplemental agreement therefore sought to bind the industrial agent more strongly and to maintain government influence after Volkswagen had acquired control. The reaffirmation of the agreed modernisation path and the strengthening of Czech control rights in corporate governance structures established important integrational institutions for cooperation intended to allay the uncertainty

about the future development of Škoda caused by the conflict. That the failure of the project could be avoided and both institutional safeguards and new consensus achieved on strategic procedure was ultimately also possible because the German group management was ready and willing to abide by the fundamental objectives agreed for Škoda. The stronger say of the Czech side in the intrinsically asymmetrical cooperation with VW is also to be seen against the background that, at this point in time, substantial transfers had already taken place, and a withdrawal would have brought considerable losses for the group—in capital and in image.<sup>22</sup>

### *New Consensus*

The group reacted to the crisis by a comprehensive cost-cutting strategy. Škoda was obliged to pursue its objectives by different, less costly means. But this did not mean that a purely cost-induced strategy, as often found in so-called low-wage locations, was to be implemented but that the crisis had necessitated re-evaluation of the specific locational profile, the combination of low costs and high skills. Strategy was redirected in three major areas.

■ *Technical equipment*: less capital-goods-intensive production. Doing without highly automatized production brought savings primarily through lower capital costs, but also through the broader use of the specific locational advantage of low labour costs.

■ *Supplies*: orientation towards local component suppliers and less foreign procurement. Reducing imports of intermediate goods from the West was intended to bring savings through greater regional exploitation of the locational advantage in labour costs.

■ *Group division of labour*: a flexible form of joint production. The aim in this field was to increase synergy effects within the group through far-reaching standardisation in products and the restructuring of development and production functions. The savings at Škoda affected aspects of research and development and involved forgoing the construction of a new engine plant.

The pursuit of modernisation under the condition of drastic cost cutting did not meet with equal Czech approval in all three areas. The continued firm commitment to cutting-edge technologies at a world market level meant that less automation was basically uncontroversial, and the greater involvement of local suppliers was warmly greeted—which is not surprising, because this point had been one of the major interests in cooperating with Volkswagen. But this could not be said of changes in the division of labour between the group and the Czech location. Since it required Škoda to outsource basic production tasks and functions, the new division of labour met with a great deal of

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<sup>22</sup> Cf. Prahalad/Doz 1987, 90 on the weakness of national governments' negotiating position vis-à-vis transnational groups prior to investment and its relative strength in safeguarding local interests once investment has been realised.

reservation and dissatisfaction. It was feared that it marked the beginning of the erosion of Škoda's status as a manufacturer and the possible permanent loss of core competencies. This has remained a fierce point of conflict with the group.

Before going into detail on the individual points, the overriding aspects of the revised strategy need to be outlined. From the governance perspective the balance had shifted between regional responsiveness (divergence) and global integration (convergence). While the cost-cutting strategy (point one) markedly strengthened convergence by reducing Škoda's autonomy and responsibilities, the cost pressure on the group (points two and three) enhanced the value-added advantage of the company over Western production sites offered by Škoda's low-cost/high-skill structure. At present the restrictions imposed therefore seem to be more in the nature of a temporary trade-off for the Czech company than a general barrier to development.

### **III. The Work Level: Group and Local Company**

A particularity in the local implementation of strategic goals needs to be stressed. A sort of 'transitional safeguard' for existing basic operational know-how was generated. Goal attainment was tied in with existing structures and realised step by step, in two phases. This was because no strategic priority was given to micro-economic rationality to the exclusion of qualitative structures and resources. There was thus no strategy to dismantle functional areas and to subject them to economic efficiency criteria, let alone to spin off areas considered unproductive or less productive, as often happens in the case of Western takeovers.<sup>23</sup> On the contrary, the preservation and integrity of the company's core areas were prioritised. From a procedural point of view, this meant reinforcing existing operational strengths through optimisation and improvement, and, in a second step, tackling more fundamental innovations over and above the status quo. This provided a bridge for the central operational base structures, which permitted the company to take the next major step in modernisation towards attaining international competitiveness.

As we have seen, this phased and gradual procedure in restructuring Škoda had two important prerequisites: first, that there were locally developed industrial structures that could provide a point of departure for modernisation, and second, that the investor—

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<sup>23</sup> This strategy predominated in privatisation and restructuring policy in East German industry, in which the government privatisation agency Treuhand assumed a sort of appraiser role, and where little account was taken of the type of enterprise. The absence of 'transitional safeguards', understood as the preservation of basic competencies through the critical phase made a not insubstantial contribution to deindustrialization. Underlying this strategy were notoriously not only political motives but also the competitive interests of West German industry, which had high overcapacities itself at the time, and was therefore anxious to combat potential East German competition. On the East German problem of industrial modernisation see Hilpert (1997).

particularly the head of the VW Group Hahn, who had initiated the project—appreciated the industrial potential of the company, and that the priorities to be set took into account not only the cost-oriented marketing aspect but also the available resources of evolved know-how and tradition. In other words, the independent development capacity of the manufacturing site needed to be fully respected. If this course was considered strategically important for Škoda, too, it was because, in view of the Japanese challenge, the strengthening of local competencies in manufacturing and engineering was considered vital to survival in the face of international innovation competition in the industry.

If, despite the greater attention to the cost principle that the crisis had imposed, VW did in fact adopt this qualitative strategy, it was attributable firstly to the terms of the cooperation agreements, which had stipulated as the guiding principle of the modernisation programme that the manufacturing competencies of Škoda and its suppliers were to be preserved, and, secondly to the realisation that any deviation would seriously jeopardise the project, as the conflict provoked by the investment cuts had shown. In the case of Škoda, the agreement thus excluded adoption of a ‘simple’ Western transfer, generally considered the easier and much less expensive procedure. If, despite the much more difficult situation, this was not considered, it was probably also because of growing competition in costs and quality in the early 90s. By that time it was already clear that, in a sector like the automotive industry that was exposed to strong global competition, the traditional cost strategies for less developed regions would come up against limits. With the general liberalisation of markets and the foreseeable inflow of Western products into Eastern European markets, it became evident that importing ‘obsolescent’ products and production models—as had been done in the 80s in China—could be only a very short-lived solution. A two-phase modernisation strategy like the one adopted for Škoda was therefore particularly appropriate in the face of the worsening cost and quality problems on the markets and within the group. It meant that Škoda products and structures could be optimised in a more cost-effective manner that both retained markets and the established clientele in the region and, because of the stronger regional base structures, provided a good starting point for the next and greater innovation phase.

## **1. Products and Competence Development**

Quality improvement was the guiding principle. It applied for both existing products and for the production system, including the local supplying industry, and constituted the core of the cooperative optimisation and innovation strategies.

With the decision to retain Škoda as a brand company, and to continue production of the Škoda product line, product improvement focused primarily on broadening sales potential in the firm’s established Eastern markets and on strengthening customer

loyalty. Škoda products' comparatively good reputation in the former Eastern Bloc countries for technical standard and reliability was first of all to be reinforced by the new status of Škoda as a VW brand and the know-how transfer from the group. At the same time, however, competing Western-standard products had to be expected as the Eastern European market opened up, and significant progress was needed to defend the company's market lead. Even if the purchasing power in the Eastern European transition economies was still extremely low for Western cars, the emerging used car market alone constituted not inconsiderable competition. This was clear, for example, from the protection the Czech government granted the domestic market for a number of years, imposing higher import duties on foreign products.<sup>24</sup>

The product improvement strategy, traditionally designed to optimise the most authentic of Škoda models, the Forman, sought to develop a new product line in the small car segment. In only the fourth year of the joint venture a successor model was put on the market. It can be regarded as the first joint Škoda-VW model (Felicia). It was followed by other variants, and now, in 1999, by a further change in the model range. These developments show that the Czech product offered a good technical basis and a potential for development, which was indeed exploited. From the point of view of quality improvement, however, a new stage has now been reached. While the first successor model had still been based on Škoda know-how, this is no longer the case with the second successor model to come.<sup>25</sup> The outcome and course of product development have become very important among employees from the point of view of identity and recognition. The fact that the successor products to come out of the joint venture were based on Škoda competence and were further developed in cooperation with VW has contributed considerably to acceptance of the project by the workforce and to their willingness to adjust, and has underpinned cooperative relations. For, although welcome, the investment of the VW Group in Škoda—a company with such standing in the Czech Republic and so important for the national economy—still aroused reservations about selling the 'jewel' in the Czech industrial crown to a German group. The product development strategies adopted, which restored the Škoda brand to its former state and status favourably counteracted this sentiment. Equally if not more important than the first step in product improvement was the second, which envisaged greater product innovation, by which the Škoda brand was successfully upgraded internationally. It

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<sup>24</sup> Still today and almost more urgently than in the first years, Škoda demands greater political regulation of the second-hand vehicle market by the Czech government. In view of the danger of monopolist pricing by Škoda and the firm's revived strength on the market, the initial market restrictions have been lifted, and so far no new restrictions have been imposed on the second-hand car market.

<sup>25</sup> In the marketing strategies for the product launch planned for autumn 1999, the company made it clear that this model had technically nothing to do with the earlier Škoda models Forman and Felicia. Particularly the older Škoda employees viewed this development with a mixture of pride in the brand name and wistful nostalgia. People were not sure whether or not the quality improvement had made a VW product out of the Škoda product and to what extent it could still be associated with the well-known Škoda competencies.

involved both expansion of the product range and entry into a higher-quality product segment. With the move into the mid-range car sector in 1996, the company abandoned the socialist monoculture with only one product in only one version. For the Škoda brand, production of the medium-sized model Octavia was an important advance in quality and image. The most striking evidence of newly won recognition and the new status of the brand is that the model achieved entry into the demanding and highly competitive Triad market Western Europe, and quickly won a relatively big market share.

The development of exports gives a good indication of the dynamics. In 1998 78% of production was exported, 60% going to the EU. This was an increase of 37% over the previous year, and the biggest growth rate so far. Most exports went to East Germany, followed by the UK, Italy, Austria, and Sweden. At the same time the company was able to maintain its leading position in Eastern Europe and at home with a 55% share of the market. Meanwhile, however, Western Europe has overtaken the Czech Republic in both unit sales and growth rates.

The answer to whether the product innovation strategy has strengthened Škoda competencies is twofold. While investment and cooperation were prerequisite for far-reaching quality improvements, the higher quality needed for the mid-sized model overtaxed the company's own resources. Only a major transfer of know-how from VW brought improvement on the scale and at the speed with which it was attained. This achievement was possible because innovation of the Škoda product coincided with a fundamental shift in the product development strategy of the group itself. The VW strategy, which had become known under the name of platform and identical parts policy, is closely associated with the name of CEO Piëch, who introduced major changes in products and production in reaction to the cost crisis of the early 90s and in anticipation of the growing competition that globalisation was expected to bring. The key to the new strategy was standardisation of the basic technical element, the chassis, also referred to as platform.<sup>26</sup> By reducing the number of platforms from 16 to 4, the strategy proposed substantial economies of scale and drastic reductions in the high and growing costs of development. For the medium and lower range products of the group, and thus particularly for Škoda (not to mention Seat), this strategy brought considerable improvements in quality, since the yardstick taken for innovation was the highest technological level available within the VW Group. The smaller brands were therefore particularly upgraded. The improvement in both costs and quality envisioned by the VW Group's platform strategy was also a response to an intensified product renewal strategy in the fiercely competitive Triad markets, characterised by a more and more rapid

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<sup>26</sup> The changes in production covered a whole range of measures including package and modular manufacture (cf the following section on the Škoda fractal factory) as well as joint production and, later, the multibrand strategy. This last strategy seeks to cover the whole range of the market with several group brands—an approach justified both by greater competition and by the associated need to be present in as many segments as possible.

succession of models—a development that would have affected Škoda products sooner rather than later. With this in mind, the platform strategy of standardisation and identical parts contributes much to enabling the profitable production of smaller numbers of units and thus to an economic advantage considered crucial in the high-volume business of the automotive industry.<sup>27</sup>

The group naturally entrusted development of the new platforms not to the small and new manufacturing sites Škoda and Seat but to its old, established brand manufacturers Volkswagen and Audi, which also had the broad know-how on VW platforms. This concentration of development know-how necessarily obliged Škoda to relinquish responsibility for development in this area and to restrict its development competence to decentralised adaptation requirements. It was this gain in innovation and loss in competence that lent ambivalence to VW's platform strategy.

The goal of international competitiveness, central to the agreement and contingent on product innovation, conflicted with the similarly fundamental objective of permitting Škoda to retain the most important core competencies of a motor vehicle manufacturer. At the outset of the project the divergence between these goals had not been anticipated, since it arose only with the new group strategy. That the centralisation strategy was nevertheless accepted without much objection is attributable firstly to the significant market progress the company would make with VW-based product innovation, and secondly to maintenance of the Škoda development division in size and importance despite the assignment of platform development to VW and Audi.<sup>28</sup> The reason was higher and steadily increasing standards in product improvement and general quality, and in more recent design requirements. Greater attention to design had been necessitated by the stronger differentiation of brands now needed for marketing purposes in view of the largely identical technological basis of the products. Although the new development tasks provided a large degree of compensation, the Czechs felt they could be no substitute for competence in the technologically demanding core area of chassis production, and that responsibility for this core product should be brought back to Škoda.<sup>29</sup>

Czech insistence on the contractual commitment to maintain the company as a fully functioning brand manufacturer shows how closely the competence question ties in with regional and industry cultural identity. It had been well understood that if Škoda joined the VW Group there would be restrictions on the independence of the company. And in

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<sup>27</sup> In 1997 a quarter of group models had been converted to the new platform, and in 1998 the figure was already 50%.

<sup>28</sup> R&D had been relatively big from the very outset of the joint venture with VW because supplier development was also concentrated at Škoda. Despite the new division of labour this division now has a staff of over 1000.

<sup>29</sup> Plans to redistribute the four platforms at a later date to all four group brands Volkswagen, Audi, Seat, and Škoda had once before been discussed. What this actually means and how extensive the respective responsibilities would be is an open question. So far Volkswagen and Audi are exclusively responsible for all strategic functional and safety components.



the knowledge that the upgrade in brand and image could not have been achieved alone, and that the shift in strategy at the product level had brought a further, significant improvement, the loss of competence ultimately proved not very controversial.

Another restriction was seen much more critically than the platform strategy, one that arose from the division of labour in the group. The issue was responsibility for new engine production at Škoda, which had also been promised under the cooperation agreement. Given the underused capacities in the West, the planned factory was not built and production at the Czech site was not launched. In view of the cooperation agreement, the compromise negotiated between the Škoda management and the group at least gave the Czech site a share in production. Even if Škoda was assigned only the simpler task of engine assembly and the German high-cost site was entrusted with the capital-intensive manufacturing, at least Škoda involvement in the new development had been secured. And in order to limit negative impact on regional suppliers, a compromise was agreed to the effect that Czech and Slovak companies would be among the suppliers of components to the German manufacturing site. This arrangement was designed to prevent a group division of labour gaining ground in which Škoda and the local supply industry would be cut off from modernisation developments. As with the platform strategy, the background was the effort to bring the development and manufacture of the new generation of engines for future Škoda products to the established site.

This phase has meanwhile been reached by Škoda owing to the expansion of capacities and internal demand. This interim solution has now proved to be an important bridge, and, with a new engine factory again on the agenda, Škoda is in an extremely good position. Not only would the project bring competencies back to Škoda but, in the context of joint production—a third of production is for Western export to Volkswagen—it would also imply higher status and broader network-related standards. Although current economic and technical conditions at Škoda are much better than in the reorganisation phase, it was far from self-evident that the firm would be successful in winning the engine production project against competition within the VW Group. In spite of the basic agreement on the issue, the group brought this new competitive element strongly into play, and now made the award to Škoda additionally conditional on subsidisation. Given the company's strong position in the Czech economy, this was granted in very large measure by the government.<sup>30</sup> The investor was thus able to push through a considerable supplementary demand in return for restoring competencies. It is striking that the Czech government held out the prospect of selling its remaining stake in Škoda to VW if the project were to be realised. Although these events show the enhanced position of power enjoyed by the company, they also reveal a change in the attitude of the Czech government, which now adopted an incentive policy in pursuit of

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<sup>30</sup> The final decision on the project has still to be made, since subsidisation amounting to a quarter of total costs triggered intervention by the EU competition authorities.

industrial objectives. This is evidenced not only by the ease with which the subsidy was granted but also by the government's recent public musings about abandoning its ownership role.<sup>31</sup>

## 2. Production Modernisation and Transfer Management

The parallel strategies of product improvement and innovation finds their counterparts in production modernisation. While gradual restructuring was pursued at the old parent works in accordance with the principles of decentralised, flexible production, the aim with the new product was to introduce a fundamentally new production system in the form of a new greenfield factory. The dual procedure was to serve the differing needs of two markets, East and West. As far as the existing production system was concerned, the structures, although backward and deficient, were still of a relatively good technological standard. In the context of local industry Škoda's pre-eminent position was particularly apparent, evidenced by a previous modernisation phase in the mid-80s.<sup>32</sup> Even if considerable changes were clearly necessary over and above the transition from plan to market, there was nonetheless a basically intact and functioning production structure.<sup>33</sup> Although the old Škoda system naturally could not match the more flexible structures meanwhile necessary in the West, and reorganisation in accordance with the new criteria was needed, radical action was not absolutely necessary because the established Eastern market was still much less demanding with respect to quality, customer orientation, and reliability. A gradual transition was thus perfectly feasible. As with product quality, however, it was to be expected that the anticipated Western competition on the market would soon raise expectations with regard to organisation, too. Mere optimisation would not suffice. More fundamental structural innovation would be needed.

The decision not to restrict ambitions to the Eastern European market but to establish the Škoda product on the much more demanding Western markets presented the production system with particularly far-reaching challenges. It is therefore no surprise that, with its sights set on international competitiveness, Škoda aspired to higher standards not only in product quality but also in organisation. The importance placed on the service function in the Western market was the main inducement for adopting a

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<sup>31</sup> Under the heading company news on 8 August 1999 the NZZ reported on the subject of "Further Privatisation at Škoda" that, in view of the good experience with the parent company and the economic progress achieved, it was intended to transfer the remaining stake to Volkswagen.

<sup>32</sup> Such developments are to be seen in the context of the Gorbachev era, which brought greater liberalisation and transparency for enterprise modernisation, too. At Škoda this affected particularly business contacts with Western firms and the procurement of modern technology (Schomer/Herkenhoff 1994)

<sup>33</sup> At the very beginning, the Western transfer management saw this in a different light, resulting in dysfunctional changes owing to an ad hoc approach not based on any extensive period of planning and without exact knowledge of the actual state of affairs (Dörr/Kessel 1997).

production concept that satisfied these requirements. The importance of the step required a high proportion of investment to be earmarked for this innovation.

The new factory at Škoda represents two new departures in the restructuring of the firm: first, a consistent, location-related design for the production system, and, second, alignment with the international state of motor vehicle production in the sense of far-reaching modernisation. The new works at the Czech site surpassed existing VW standards, following a model that was very advanced from a Western point of view. It combined the specific locational low-cost/high-skill structures with the more recent principles of modular production.

In organisational design, the much discussed ‘fractal factory’ model has been consistently implemented. The modular principle is applied not only in manufacturing in the narrower sense but also in development of the new product. The better coordinated and more closely related functions of development, production, and organisation permit greater processual coherence. With regard to work organisation, the new production system displays elements meanwhile common in the industry, including decentralisation, flatter hierarchies, group and team work structures, and more strongly communication-based coordination. At Škoda the greater flexibility typical of modular manufacturing—associated with new possibilities of insourcing and outsourcing, which allow more complex subsystems to be entrusted to subcontractors—is linked with close integration of such so-called system suppliers. The characteristic feature of the Škoda fractal production concept is precisely the extent of supplier integration. System suppliers were located not only in the immediate vicinity of the manufacturing plant and in surrounding industrial estates—as has traditionally been the case in Western locations in keeping with the just-in-time system—but directly in the plant, and directly integrated into the production process.

The prerequisite for the viability of such a far-reaching model, which basically dissolves traditional dividing lines between plants and gives rise to diversified working relations, was a high degree of *uniformity in pay and working conditions*. This was due to a regional characteristic rooted in both local industry culture and union policy. In contrast to Germany, there are no notable pay differentials between manufacturers and suppliers, elsewhere a factor in social conflict. Moreover, trade union policy was strongly guided by a principle of equality opposed to any major differentials between employees and to more than one union in a company. Sole representation of worker interests by the company group of the Czech metal workers union KOVO obviated another source of tension. A third factor was equalisation of the social standards of manufacturer and the integrated suppliers. Concessions were achieved upon introduction of the model, for example the use of the company infrastructure and retention of entitlements upon transfer to a supplier. Thus a high measure of homogeneity could be attained also in corporate culture standards, counteracting the model’s potential for ‘social fractalisation.’

The *level of automation* was also *much lower* than in the West. In this regard the production system reflects the generally lower pay levels in the Czech Republic and the region.<sup>34</sup> As we have seen, however, this factor gained its current importance only with the cost crisis in the VW Group. The Spanish subsidiary Seat, the reference model for Škoda, had still been provided with a technology-intensive production system. Emphasis on labour rather than technology was one of the central elements in the cost-cutting strategy pursued at Škoda. The impact of this reorientation went beyond the company, for it was the first disavowal of the rationalisation and modernisation course typical of VW.<sup>35</sup> This rethinking is to be seen not least of all in the context of the lean-production debate that arose in the 80s, which focused on the strong technology orientation in the automotive industry as a key problem of the German production model. Under changed global competitive conditions, with higher cost and flexibility requirements, the competitiveness of the ‘over-mechanised’ VW path had long been considered limited.

Measured against the economic and labour resources of the production system, what initially seemed a limitation has proved a new enablement. For the lower level of automation not only averted high capital costs to the advantage of the company; the concept offered another opportunity with respect to labour policy. The firm commitment to both technically demanding skilled jobs and to simple jobs was due not only to a more flexible deployment strategy. The provision of jobs across this spectrum also had the important labour market effect of safeguarding employment both for the—in principle—strong group of skilled and highly skilled employees and for the low-skilled and unskilled.

Another aspect of this production concept is its implications for the safeguarding of the company’s competence as a manufacturer. For the specific combination of factors offered by Škoda—low labour costs plus low capital costs—there was no need from the cost point of view to pursue the lean production principle as intensively as in the West. This was apparent from Škoda’s greater vertical range of manufacture.

It can be assumed that the reduction of automation levels in the Škoda production concept sent a signal to other VW Group investment projects in the region. A lower degree of mechanisation was also envisaged in the later production concept adopted by

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<sup>34</sup> In the earlier transition years, wage levels were lower in the Czech Republic than in Hungary and Poland. In comparison to Germany the pay differential was 1 to 10. Although wages in the Czech Republic have risen considerably in recent years, this differential has still not changed much. Moreover, pay rises at Škoda are accompanied by substantial rises in productivity, so that higher wage costs can be more than offset. The growth in productivity has been 12% annually, and last year it reached 17.4% (Škoda director of production Büsching in *AutomobilProduktion* 4/1999, 28, Škoda annual report 1998).

<sup>35</sup> This is not the place to judge the extent to which the capital-intensive VW model is attributable to the philosophy of Hahn’s predecessor or whether it can be regarded as a general element of German engineering culture that was put to the test only with the intensification of cost competition in the field of development. In speeches assessing Czech industrial enterprises shortly after 1990, Hahn identified not only high manning levels but also inadequate technology as a key deficiency, and called for substantial technology transfer to Škoda (cf. Keller 1993).

the VW subsidiary Audi at Győr in Hungary, where there was also a specific combination of very capital-intensive and very labour-intensive functional areas. And the site in Slovakia is particularly typical in this regard. One of the VW Group's bigger investment projects, it had the lowest mechanisation level, not exceeding 35% even in the more highly automatized areas.<sup>36</sup>

It remains an open question whether the mixture of capital-intensive and labour-intensive functional areas at the Eastern manufacturing sites reflects the regional structure of low labour costs and skilled labour, and can thus be considered specific to the region, or whether it is a more general structural element of the new production system prompted by the new competition in quality, market share, and costs. However, there is evidence that intensified competition favours such a constellation. If this is the case, the Eastern Central European region with its typical low-cost and high-skill conditions may well have a production model more competitive than that of the West.

The establishment of a new production system with such far-reaching consequences would have been unthinkable without the transfer of skilled labour and management for restructuring purposes. The services of a large contingent of expatriates were made available to implement the high standards of quality set by the group. Almost 300 skilled workers and managerial employees, who were deployed at Škoda for a limited period, had the task of optimising all core areas of the company as quickly and comprehensively as possible, and setting up the competence areas such as marketing, sales, and controlling which had been lacking for systemic reasons. Whereas Western managers were strongly pre-dominant in these areas, this was not equally the case in production and development, which were the strengths of the company, and where further training was concerned 'only' with bringing competence up to scratch.

Since such a constellation—the reorganisation of an old-established company, a change in system, global competition, and a high-power modernisation concept—was unprecedented, and since the investment project involved was extremely large, the transfer procedure applied was unusual and elaborate. So-called tandems, double appointments to leading positions, were intended to facilitate knowledge transfer and restructuring during running production. The transfer procedure thus reflects the basic strategy elements of resource preservation and innovation. However, the tandem structure with formal equality of status internally and with no division of labour and responsibilities did not prove a simple instrument. For a system aiming to permit the greatest possible exchange of experience and knowledge in a narrow process of (every-

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<sup>36</sup> This is particularly evident when comparing Bratislava with the other group sites also responsible for Golf production. Traditionally, automation is most advanced at the parent plant in Wolfsburg. The works in Brussels and Mosel in East Germany are approximately at the same level in the areas of pressing, prime construction and paint work (85 to 90%), but are at only about 30% of the Wolfsburg level in assembly. Bratislava does not exceed the 35% mark in any area (Weißgerber, Markenvorstand VW in AutomobilProduktion 10/97, 56).

day) collaboration was confronted by the classical leadership notions and clearly circumscribed areas of competence usual in industrial enterprises—on both sides. Moreover, the structure of power was often very inequitable, despite formal equality, firstly because of the knowledge asymmetry between actors and secondly because of the arrangements for appraisal of the Czech tandem partner's performance. These structural conditions were joined by another circumstance. A not inconsiderable number of the Western transfer personnel knew little about the region, and some of the actors still had little professional experience. This provoked defensive reactions and conflicts not only in the immediate work process but also attracted a considerable amount of attention in the company—albeit in limited, isolated cases. Preconceptions about German arrogance were activated, and such cases were seen as evidence of a lack of recognition by the cooperation partner, who—it was claimed—had in part sent Škoda 'third-class management.' This tense situation among personnel was greatly exacerbated by the group crisis and investment cuts.

Consequently, the partly objective partly emotional conflict structure had a substantial impact on the transfer process and on cooperation. However, it also generated a challenge. For the high value that local actors placed on the Škoda tradition and sound basic competence in car making counteracted a one-way notion of transfer and cooperation and obliged Western actors to proceed with greater sensitivity. This countervailing factor, which demanded more discussion and persuasion, successfully opposed the sometimes overt, sometimes implicit arrogance of Western transfer management. Furthermore, it contributed not inconsiderably to the restructuring being understood as an undertaking that, in the combination of local resources and transfer knowledge, demanded solutions other than the tried and tested ones envisaged. Although the situation thus demanded a great deal of the Western actors, it offered them a much appreciated possibility to use the relatively broad scope for action available for personal initiative. For in comparison with structures at Volkswagen, Škoda—with its 20,000 employees much smaller than Wolfsburg—and the ongoing restructuring process at the Czech location offered broad scope for change and for trying out new ideas.

The new factory was particularly promising in this respect. However, the greenfield strategy of constructing a completely new plant, reputedly easier to realise than structural reorganisation, turned out to be not without problems. Recruitment was the main one. In order to make as few concessions to the old Škoda culture as possible and to avoid transferring it to the new structure, internal applicants were excluded. People were recruited only from outside the firm, and a costly training programme for this group was put in place. That the wide-spread managerial notion of 'handpicked personnel' is not of itself the better solution became clear when most of the new workforce left after a brief period. The Czech labour market was very limited because of the long delay in

restructuring local industry,<sup>37</sup> and there was a very high demand in local firms for such people with higher qualifications. This experience provoking rethinking about the generally negative appraisal of the corporate culture, and aspects like length of service and loyalty, identification with occupation and work were reassessed.

There was a conflict and learning situation requiring similar rethinking among the workforce. The cause was the new form of production system. Since some of the structural elements recalled the old socialist system, there was initially a great deal of scepticism towards the innovations. There was the strong emphasis on the production level owing to decentralisation, the importance of networked, informal hierarchical structures as opposed to clear, normal hierarchies; and there was the particular stress placed on team and group work, which smacked of brigades and work collectives, or the so-called CIP activities, which could be interpreted as a variant of socialist competition. The irritations and reservations that these structural similarities caused were so great because they were not in tune with the ideas of efficient and rational production organisation—ideas that had developed among the relevant groups like skilled workers and engineers in taking their distance from the deficient structures hitherto experienced. What is more, quite different expectations with respect to organisation were levelled at the German partner, in particular, with regard to efficiency and the suitability of structures. With the upturn in the fortunes of the company and growing confidence in handling the structures, the production system is now seen in a different light and the initial reservations have proved unjustified.

### **3. The Supply Industry and Integration**

With the dual strategy of preserving and ameliorating the current product line and of product innovation, the VW-Škoda project impacted not only the company itself but also the local supply industry. The established supplier network was basically retained and integrated into the reorganised structures of the manufacturer. A gradual transition process was therefore able to take effect here, too, which preserved a high measure of structural resources.

Naturally, the motive for Škoda's commitment in this field was ultimately economic, to exploit the cost advantages in the region not only in the narrower sense of in-house production but also through maximal local sourcing. This explains why the supplier issue was never a point of fundamental controversy between the group and the Czech government in the history of the Škoda-VW project, because the interests of both sides were highly congruent and local sourcing was an obvious solution precisely under the dictates of the group-wide cost-cutting strategy. Avoiding a high proportion of imported

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<sup>37</sup> In the first transition years, the Czech unemployment rate was between 3% and 4%, about three to four times lower than in the neighbouring countries Hungary and Poland. In the area around Mladá Boleslav, where Škoda is located, the figure was 1%.

components must also be seen in the market and price policy context. Since Škoda operates in a much lower price segment than the two established group brands Volkswagen and Audi, the costs for the comparatively expensive imported supplies can be passed on to the market only to a very limited extent.

Škoda gave high priority to further training for local suppliers. Here, too, there was a personal aspect in play. For during the early years of the joint venture, the firm had been headed by two people regarded as authorities on Eastern European industrial structures, and who did much to promote the development of the regional supply industry. The first, on the Czech side, was a representative of the local supply industry in the person of the chief executive officer, and the second, on the German side, his deputy, the long-standing representative of the group for business relations with Eastern Europe. This, too, gave high strategic salience to the supplier problem at Škoda.

The most important upgrading strategy was cooperation with Western firms. Over and above this, know-how was transferred through an internal training programme for suppliers. The purpose was to allow local companies, too, to restructure to meet the new demands in quality and flexibility as quickly as possible. VW's investment in Škoda thus had an important spillover effect on the local supplier industry. Until the end of 1997, almost one fifth of all foreign direct investment in the Czech Republic flowed into the automotive and supplier industry (CzechInvest 1998, 5). In contrast to Hungary, which had no comparable sectoral structures, and where greenfield projects predominated, the Czech Republic had a high proportion of joint ventures and takeovers. Some 80 joint ventures with local firms have so far followed the VW example. In addition, 50 new Western companies have been set up.

Another, more political motive for actively promoting local suppliers was the stagnation in corporate restructuring the Czech approach to transformation had caused (see below). Given the delay in corporate transformation in broad sections of local industry, the company management made a determined effort to forestall any crisis by creating a competitive and stable network of suppliers transferring know-how and supporting East-West joint ventures.

Product innovation under the platform strategy and the new, modular production concept brought major changes with a substantial impact on relations with suppliers. Centralising responsibility for the chassis platform meant that Škoda is far more strongly committed to the group network for supplies. This opened a cleavage between the group and the production site. From the cost point of view alone, integration in VW's platform and identical parts policy was far less beneficial to Škoda than to the German brands, because in principle it diminished the advantage to be derived from maximum locally added value. What from the group perspective generated substantial savings through standardisation and higher economies of scale, and which furthermore countered the problem of overcapacities in German plants through the concentration of



responsibilities, meant much high expenditure on Western imports for Škoda. The difference between the total cost perspective of the group and the standpoint of the individual firm reflects one of the more general conflict structures of such transnational corporate networks, and reveals the divergence between the interests of the superordinate group and those of the regional production site.

The impact of the platform strategy is particularly striking in the changed sourcing ratio. Although the strong expansion of capacities at Škoda's, which doubled production, also more than doubled local purchasing, the ratio of local to global content shifted in favour of foreign imports. In 1996, 80% of procurement was local, but by 1998 the figure was only 70%. With the successor model in the small car series, also to be based on a VW platform, local sourcing will decline further. The share of imported Western components is likely to rise to 40%, the level already reached for the current mid-range model.

These consequences of the new production concept primarily affect the structure of supplier relations. For product and process innovation in the form of modular manufacture has induced a general structural change in the sector (Dörr/Kessel 1999a). The modular principle made it possible to split production into larger units, which can be completed relatively independently of one another. This also made it possible to outsource more comprehensive production tasks, or to assign them to suppliers. Overall, this meant changes in the division of labour between manufacturer and suppliers. Transferring complex tasks involving a greater development competencies to the supplier industry has brought stronger concentration and fostered group structures.

The manufacturer's more demanding requirements in the provision of complex systems set a mark too high for the Czech supplier industry to reach unaided. It was thus not surprising that locally established Western suppliers assumed the key role of so-called system suppliers for Škoda. For the internal differentiation of local content, this means a clear concentration on this similarly internationalised area, which, at least as far as system suppliers are concerned, can be assumed to generate a substantial proportion of value added through the group network. Expressed in figures, one fourth of Škoda purchases are from the eight system suppliers directly integrated into the company. 60% are from 80 locally established international suppliers. A total of 680 Škoda suppliers is reported (AutomobilProduktion 4/1999, 30).

There is a factor that could counteract the limitation of locally added value implied by the platform strategy and the development of system suppliers. It is the principle of global sourcing endorsed by the group's cost cutting strategy, which aims to broaden a cost-effective supplier basis. This could present (local-international) supplier firms in the Czech Republic with far-reaching options. And the further training Škoda organises for the local supplier industry is to be seen not least of all in this context, namely as an

endeavour to open up the region for supplies to the group over and above Škoda itself.<sup>38</sup> For the Czech supplier industry, links with the group network could thus in some measure compensate the decline in local content at Škoda.

Taking stock of developments with regard to the supplier industry, Škoda has thus retained a relatively high level of regional integration, or has re-established it in modified form, despite the restrictions imposed by the platform strategy. Restructuring through internationalisation (Dörr/Kessel 1999a) has thus permitted component makers to build a high level of capacity through know-how transfer to meet international competition in quality, flexibility, and costs. The automotive industry is among the most important growth industries in the Czech Republic today. Some 3% of all jobs are in this sector,<sup>39</sup> and it produces 11% of the country's entire industrial output. The importance of the industry for the national economy is also indicated by export data. As the company with the highest turnover in 1998 (DM 5.6 billion), Škoda alone had a 9.2% share in the country's total exports. Suppliers add a further 5% (Severoceske Noviny 8 June 1999).

Seen in the overall context of Czech industry, the importance of developments at Škoda and in the supplier industry for the Czech economy is particularly apparent. Macroeconomic data indicate a persistent downward trend in growth rates for industrial production and labour productivity (WIIW 1999, 7). Production growth also differs greatly between the strongly internationalised motor vehicle manufacturing and components industry and local industry. On the basis of 1991 figures, Škoda reached a score of 224 and the rest of Czech industry only 74 (NZZ 15 March 1999). It is clear that the enormously high rate of growth in the automotive and supply industries has had an important positive impact on the macroeconomic position, but an extremely dangerous gap has developed between the international company sector and domestic industry, dangerous also because the economically powerful big firms in the international sector have a strong external orientation, being integrated into transnational supplier and production networks. While this new cross-border exchange structure gives companies like Škoda a highly developed propensity for cooperation, there is a marked trend in favour of international partners, whether locally established or within the VW Group.

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<sup>38</sup> The importance that purchasing has gained is also indicated by the establishment at group headquarters of a Corporate Sourcing Committee, which decides on the selection of suppliers. Worldwide purchasing is divided into four major regions, each in the charge of one of the high-volume brands of the group. Under Škoda's responsibility for Eastern Europe, 80 firms have so far been won as suppliers to the group, and efforts are being made to increase this number.

<sup>39</sup> The total population of the Czech Republic is 10.3 million, with a labour force of 5.3 million (CzechInvest 1999a). With its 23,000 employees, Škoda is one of the biggest employers.

#### IV. The Political Level: Government and Local Industry

Recalling our initial thesis of the relevance of the transformation regime for industrial competence development, we take a perspective on the role of government that again goes beyond the Škoda case. For Czech industry as a whole presents a far less positive picture than the Škoda complex. In short, the Czech Republic has adopted a two-track approach to restructuring, involving both defensive stagnation and strategic innovation, with the dividing line running between local and internationalised industry.

Although the policy for the traditional second pillar of Czech industry, mechanical engineering, had also been to safeguard existing competencies, in contrast to the automotive industry it was decided to adopt a national restructuring approach that basically excluded foreign investment. Like the motor vehicle construction and supply industries, mechanical engineering is dominated by a limited number of key firms, the conglomerate Škoda Pilsen and CKD Praha. Here, too, foreign investors were in the offing, but no prospect of a far-reaching sales and restructuring strategy was proffered as when Škoda Auto was privatised. To avoid lucrative business segments being sold to foreign investors, which would also have meant hiving off and losing upstream and downstream competence areas, a ‘national solution’ was adopted to preserve the companies in the sector as far as possible. This doubtless counteracted break-up and deindustrialization processes such as took place in East Germany, but developments showed that adequate modernisation was impossible without support, and that the strategic objective of structural preservation operated to the detriment of international competitiveness. Mechanical engineering is consequently under growing pressure to restructure, and it is highly questionable whether the ambitious goal of comprehensively preserving regional competence can be upheld.

The case of the mechanical engineering group Škoda Pilsen is interesting not only from the restructuring point of view. It is also a Czech attempt to support a sector in the hands of local owners. Approval for the management’s strategy of expansion by acquiring and integrating other major companies (including the heavy goods vehicle makers Liaz and Tatra) can be interpreted as signalling ‘national global player’ ambitions.<sup>40</sup> The dominance of big companies and conglomerate structures—which had in part increased still further during transformation—together with the failure to develop the small and medium-sized sector, can be regarded as specific to the Czech path to transformation.

The Czech case is particularly instructive, because the country had long been considered a model for successful transformation, and the economic policy of the non-socialist

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<sup>40</sup> Škoda mechanical engineering is not an exception. Similar strategies have been adopted by the chemical industry, for example, especially the Chemapol group, which not only wanted to underpin its leading position in the industry through acquisitions but also sought intensive diversification through participation in manufacturing firms (NZZ 23 December 1997, Handelsblatt 6 October 1998).

conservative government under prime minister Vaclav Klaus enjoyed high international regard. Although company studies had drawn attention at an early date to the failure of broad sections of local industry to restructure (Clark/Soulsby 1995, Carlin et al 1995 and on the course of restructuring at Škoda mechanical engineering, especially Hayri/McDermott 1995, Tänzler/Mazálková 1996), this problem was not recognised for a long time by macroeconomic structural analyses (e.g., Kosta 1997).<sup>41</sup> It was only with the critical downturn two years ago that prevailing transformation policy was revised and a political turnaround took place in the Czech Republic.

In the Czech approach to transformation, three key policy choices were largely instrumental in provoking the serious setback at such a relatively late stage: the privatisation model, the one-sided concentration on macroeconomic stability goals, and, finally, restricted access for foreign capital and a defensive direct investment policy.

#### a) *Privatisation Model*

The Czech Republic had more rapid success than other transition countries in privatisation, one of the basic regulatory requirements in transforming the economic system.<sup>42</sup> A key element was so-called voucher privatisation, allowing the public to acquire share options in productive property (for details on Czech privatisation see Mertlik 1996 and Windolf 1999). This permitted the rapid conversion of state property into private property but produced ownership configurations doubly disadvantageous for corporate restructuring. First, the small-shareholder structure prevented the inflow of investment capital and know-how needed for modernisation,<sup>43</sup> and no effective corporate governance structures developed capable of contriving deglomeration and strategic re-orientation.

The frequent governance problem is mainly the result of the high level of debt between companies and vis-à-vis the banks, and of soft budget constraints, which allow inefficient and unprofitable firms to survive. The close links between firms and the financial system have been identified as a serious weak point in Czech transformation (WIIW 1999, Pöschl 1998). While the (non-privatised) banks often play the double role of creditor/lender and owner representative, the crises of major debtor firms jeopardise bank liquidity. Under these conditions, further loans are granted to major loss-making

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<sup>41</sup> There was a whole range of reasons. Among the main ones was doubtless that domestic industry had initially been able to hold its own in its traditional Eastern markets. However, the discontinuation of exports to Russia could not be compensated by a greater share in the demanding international markets in the West. Despite currency-related price advantages, Czech competitiveness in up-market segments was limited.

<sup>42</sup> As early as 1996 some 80% of industry had been privatised (Kosta 1997, 8). This figure is high not only in comparison with Poland and Hungary but also considering that much more of the Czech economy had been state owned than in the neighbouring countries. (Heidenreich 1994).

<sup>43</sup> See Windolf 1994 for a seminal treatment of the problem of small shareholders in supervisory bodies and the interest in short-term profits versus strategic investors' long-term profit orientation.

companies, and—owing to the far-reaching social and industrial consequences—bankruptcy law is often not applied in the case of such major firms. All in all, the privatisation model and the lack of effective governance institutions have produced a sort of tripartism in Czech industry between firms, banks, and government, which strongly upholds structural persistence, and which has provided only insufficient conditions and/or incentives for corporate restructuring.

#### b) *Macroeconomic Stability Goals*

For two reasons the Czech Republic has pursued a policy far more closely guided by considerations of macroeconomic balance than in other transition countries. First, the point of departure was much more favourable than in neighbouring Poland and Hungary: the budget, for example, was balanced and foreign debt was low, making such a course appear more viable. Second, the government had adopted the neo-liberal position of intervening as little as possible in the economy, largely eschewing any active industrial policy. The background was a grave misjudgement of the situation, not only with regard to the process policy controls needed despite good ‘initial equipment’, but especially with respect to continuity of action by the players involved. In short, the main problem of Czech economic policy was that structures and control instruments tried and tested in Western market economy contexts were deployed without taking account of the transformation situation, without taking sufficiently into consideration that the prevailing structures and conditions for action differed from those in an established market economy. The key economic agents thus assumed that the introduction of market and competitive principles would more or less automatically reorient action towards the pursuit of economic rationality.

A look at industry reveals the consequences for the government’s anti-inflation policy of such a foreshortened institutional understanding of transformation. For although strict control of the money supply succeeded in keeping inflation down, the high interest rates made it more difficult, especially for small and medium-sized firms, to obtain the loans necessary for investment. Just as fatefully, the big companies, already deeply in debt, reacted not with greater financial discipline but by borrowing still more (Pöschl 1998). Precisely the conditions outlined, with banks and industry closely interlocked, allowed big firms to espouse such survival strategies. For consistently market-oriented behaviour, both the institutional setting and the prerequisite action orientations among lending banks and borrowing companies were lacking.

It is therefore a general problem that economic agents failed to behave as expected; in other words, that economic policy presupposing a functioning market economy and control mechanisms ignored the institutional contextualization. There was also a lack of backup measures to establish a link or a balance between macroeconomic stability goals and company-level restructuring requirements. Old structures were thus further

consolidated and the national economy has had to shoulder a very heavy burden of (government) support for highly indebted big companies.

c) *Limited Access for Foreign Investment*

With its only recently abandoned defensive direct investment policy, the Czech Republic differed fundamentally from other transition countries. Whereas Poland and especially Hungary made attracting foreign direct investment a priority policy goal, there was no specific incentive programme for foreign investors in the Czech Republic. Apart from a few large-scale projects like the privatisation of Škoda Auto or in the telecommunications industry, for which special conditions were negotiated, the Czech government took a restrictive attitude. That the inflow of foreign capital, although not officially restricted, was not actively supported points to two further aspects of the Czech path to transformation. First, the need to deglomerate and modernise was underestimated because the industrial preconditions had been better than in neighbouring countries. Second, strong emphasis was placed on independence, which the sale of key industrial enterprises to Western investors and the influence they would consequently acquire was considered to jeopardise. This last attitude can be seen as a reaction to historical experience with the Soviet regime, which—as in other transition countries—reinforced national identification, and made national sovereignty an important political topos.

Although both viewpoints can be understood in the historical context, they are not unproblematic in the changed international environment confronting the transition countries. Not only had direct investment become much more important for national economies under the conditions of globalisation, but the decision to apply for EU membership set a course that placed national sovereignty on a new basis. Accelerated economic internationalisation and political transnationalisation now face the transition countries, processes to which the West had been able to adjust gradually, but which the transition countries now have to cope with overnight, as it were.

Finally, we turn in brief to the shift in policy provoked by the economic crisis in the Czech Republic.<sup>44</sup> One of the most marked changes has been the abandonment of the national transformation path hitherto pursued. Since 1998, legislation has been in force that provides for tax relief and state aid for large-scale investments,<sup>45</sup> which—according

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<sup>44</sup> The turnaround had already been initiated under the Klaus government. Confronted by steadily worsening economic performance figures and a financial scandal, the government resigned in late 1997. Until the early elections in mid-1998, a transitional government under the head of the national bank, Tosovsky, took over.

<sup>45</sup> Investment incentives are granted for projects worth at least \$ 10 million. The incentive package includes the following measures: five year relief for corporation tax, subsidies for new jobs and for initial and further training, infrastructure, duty-free imports of machinery and equipment, production in free zones (CzechInvest 1999b). The incentive package adopted in December 1998 is an amended version of the April 1998 arrangements. The main changes are a reduced minimum investment (from \$ 25 million to \$ 10 million) and higher support per new job, from \$ 2,500 to \$ 3,300.

to not uncontroversial official statistics—has led to a significant rise in foreign direct investment.<sup>46</sup> Despite this positive signal, the Czech economy continues to suffer from serious restructuring deficits in local industry. The structural policy omissions of the early years are likely to have had a particularly deleterious impact. For not only are neighbouring countries now well ahead of the Czech Republic in building up a functioning market-economy institutional system, especially in banking, but opaque corporate governance structures and rising corporate debt offer little incentive for prospective entrepreneurial investment and Western cooperation projects.

Another important factor in this context is the political enforceability of so drastic a reform programme—envisaging the deconcentration and consistent market orientation of major enterprises—not only with regard to strategic actors in management but also in view of the social consequences.<sup>47</sup> Another curb on political action in the Czech Republic is the lack of a reliable majority for the minority Social Democrat government that has been in office for the past year. The stalemate emerging from the elections imposed a tolerance pact with the largest opposition party headed by former prime minister Klaus. This arrangement, designed to retain power for the governing party and safeguard the influence of the opposition, has strongly restricted the new government's scope for action, since it has to woo support in the opposition camp for every item of legislation, resulting in political stability at the price of stagnation. Nonetheless, there are signs with regard to local industry that, with the prioritised reform of the banking industry, stricter conditions for lending and in enterprise control are now taking effect, imposing more fundamental reorganisation on the major conglomerates.<sup>48</sup>

This is also the case with industrial policy, which in the first years of the Klaus government had not been purposively and actively pursued. This course was abandoned only when the crisis could no longer be ignored and external pressure on the government increased appreciably. From this point of view, the Czech Republic can be said to have followed a strongly traditional-national path to transformation, despite the formal opening up of the economy and the Western orientation of policy. The change in policy was the outcome of forced 'learning' from the crisis and from external criticism, articulated chiefly by the supranational organisations EU and OECD, which have

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<sup>46</sup> The amount of \$ 2.5 billion is recorded for 1998 as compared with \$ 1.4 billion in 1996 and \$ 1.3 billion in 1997 (CzechInvest 1999a, 2). The total is given as \$ 11 billion. The Czech Republic is thus still behind Hungary as a country comparable in size, but the gap appears to be gradually closing.

<sup>47</sup> See also the criticism of President Havel, who pointed to the difficulty of winning the population at this late stage in the transformation process for drastic social privations and sacrifices that would have much been much more willingly accepted in the initial stages of transformation. A difficult social psychological factor is likely to be the loss of economic front-runner status, which was highly prized in the Czech Republic. Havel's invective is also instructive in this regard, because he calls for a moral orientation in Czech politics going far beyond purely economic interests (FAZ 10 December 1997).

<sup>48</sup> Primarily the sale of corporate units and interests in firms, and the intensified search for strategic partners in the West (Handelsblatt 6 October 1998 on the sale of Škoda Pilsen subsidiaries for debt repayment purposes).

recently intensified their censure of inadequate institutional reforms, particularly in the key area of corporate governance. It is not yet clear whether such an externally provoked shift in policy indicates a shift in attitude on the part of the political and economic elites. Nevertheless, there is some sign that greater emphasis will be placed on the internationalisation component in restructuring. However, given the currently weak negotiating position, it is questionable whether the central goal of comprehensively safeguarding industrial competence—as in the case of the Škoda Auto privatisation—can be achieved.

## V. Conclusions

Especially with developments in local industry in mind, the example of Škoda shows that internationalisation has been a key element in successful change. In facing global competition, it was vitally important that Škoda's partner in cooperation not only had the necessary financial resources but also disposed of networked knowledge and relations, and that restructuring was broadly based on this principle—from product development to production system, including intercompany structures.

A second, equally important aspect, which gave the lie to the notion of a 'sell-out' of domestic industry to foreign investors, was the preservation of regional embeddedness and the safeguarding of fundamental competence resources through cooperation. Even though preconditions for the Škoda-VW project had been particularly good, and the partners' interests very largely congruent, institutional embeddedness still proved indispensable for the long-term maintenance of regional ties in their qualitative substance. One reason why the project survived even major crises and conflicts is doubtless the high strategic objectives of both parties to the joint venture. These objectives provided an effective framework for negotiating arrangements and compromises between the two parties, making flexible adjustment possible without endangering the basic balance of interests. In other words, this framing established a mechanism that prevented often very conflictual demands from provoking an either-or conflict.

Two other factors also made an important contribution to this outcome: first, cultural commonalities, especially on the subject of production and technology (high regard for technical and scientific standards), and, second, confidence, growing in the process and engendered by the technical and economic successes attained, that Škoda would largely achieve the development goals that had been set. Škoda's greater willingness to accept trade-offs and the shift from a closed-national identification stance to a national-international posture as a member company of the VW Group is to be understood in this broader context.



As far as the national transformation regime is concerned, the Czech approach of weak to absent industrial policy governance produced a wide gap between the international and domestic sectors. It hindered potentially broader spillover effects and intersectoral links in the region from developing adequately or at all. Not only is the consequent gap between the two areas of the economy wide and have disparities grown: this regional structural deficit has also had the unwanted effect of intensifying the trend among locally established international firms towards external orientation. Overall, this shows how much the dynamization of existing resources and potential depends on interaction between transformation agents and on the creation of equivalent structures that make intercompany exchanges possible in the first place and which work towards fulfilling the new prerequisite of more comprehensive 'cooperation platforms.'

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Dr. Gerlinde Dörr

Wissenschaftszentrum Berlin für Sozialforschung gGmbH

Reichpietschufer 50

10785 Berlin

Tel. 0049-30-25491-116, Fax -127

E-mail: [gerlinde@medea.wz-berlin.de](mailto:gerlinde@medea.wz-berlin.de)

Tanja Kessel M.A.

Wissenschaftszentrum Berlin für Sozialforschung gGmbH

Reichpietschufer 50

10785 Berlin

Tel. 0049-30-25491-292, Fax -127

E-mail: [tanja@medea.wz-berlin.de](mailto:tanja@medea.wz-berlin.de)

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